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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

August 1, 2000

Ms. Magalie Roman Salas
Secretary
Federal Communications Commission
445 12th Street, S.W.
12th Street Lobby, TW-A325
Washington, DC 20554

Re: Ex Parte Presentation in WT Docket No. 99-217 and CC Docket No. 96-98

Dear Ms. Salas:

On behalf of the Smart Buildings Policy Project, Gunnar Halley, Christopher Duffy, and the undersigned, all of Willkie Farr & Gallagher, met yesterday afternoon with Jeffrey Steinberg, Lauren Van Wazer, Joel Taubenblatt, Paul Noone, and Richard Arsenault of the Wireless Telecommunications Bureau to discuss matters related to the above-referenced proceedings. Specifically, we discussed the analysis contained in the recent decision of the Massachusetts Department of Telecommunications and Energy concerning telecommunications carrier access to tenants in multi-tenant buildings. In addition, we noted that the Cable Services Bureau, in Cavalier Telephone v. Virginia Electric and Power Company, File No. PA 99-005, *Order and Request for Information*, DA 00-1250 at ¶ 7 (rel. June 6, 2000), explained that the Eleventh Circuit's mandate from *Gulf Power II* had not yet issued.

We discussed some reasonable interpretations of Section 224 that would recognize rights-of-ways on multi-tenant building rooftops. We mentioned that, in their ex parte submissions to the Commission, some building owner-affiliated carriers have described themselves as CLECs, literally acknowledging their LEC status and the Commission's jurisdiction over them. Moreover, these building owner-affiliated CLECs (or "BLECs") are obtaining rights-of-way to rooftop space from building owners.[1]

We directed the Commission participants' attention to Winstar Communications Inc.'s July 12th written ex parte submission in the above-referenced proceedings. In those materials, as well as in the Cypress Communications SEC Form 10-K filed March 30, 2000 with the Securities and Exchange Commission (a copy of which is attached hereto as Attachment 1), the incentives for building owner discrimination in favor of carriers in which they maintain a financial interest become more apparent. For example, in the above-referenced 10-K, Cypress states that:

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1 See, e.g., Yankee Group at 17 (filed as a written ex parte submission by Winstar Communications in the above-referenced dockets on July 12, 2000)("Like many of its competitors, [Broadband Office] has also secured roof rights and plans to use wireless as a secondary or redundant method of access."); see also id. ("While [Allied Riser] has not yet provisioned physical fiber diversity into any of its currently served buildings, it has secured roof rights-of-way for use of wireless fiber as a default transport alternative.").

> If . . . potential competitors successfully focus on our market, we may face intense competition which could harm our business. In addition, we may also face severe price competition for building access rights, which could result in higher sales and marketing expenses and lower profit margins. . . . Certain competitors already have rights to install networks in some of the buildings in which we have rights to install our networks. It is not clear whether it will be profitable for two or more different companies to operate networks within the same building. Therefore, it is critical that we build our networks in our target buildings quickly, before our competitors do so. If a competitor installs a network in a building in which we operate, there will likely be substantial price competition.[2]

Building owners have identified telecommunications as an important component of their revenue stream and are becoming increasingly involved in telecommunications.[3] Some real estate entities seek to enter the telecommunications field directly either through direct investment in telecommunications entities or by spinning off telecommunications affiliates.[4] Others seek to share in the revenue derived from telecommunications through revenue sharing or by taking warrants in the telecommunications providers serving their buildings.[5] Still, other building owners view telecommunications as a component of real estate and seek to ensure that their tenants have access to the most advanced and diversified telecommunications capabilities available, regardless of provider. These latter group of building owners may charge for access. However, their interests tend to lie not in the revenue derived from the carriers but rather in increasing the attractiveness of their buildings to potential tenants and in outfitting their buildings with advanced telecommunications infrastructures.[6] To some degree, the manner in which the building owner is

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2 Cypress Communications Inc. Annual Report, "Risk Factors That May Affect Future Results," (SEC Form 10-K), filed March 30, 2000.

3 Deutsche Bank at 22 ("In our opinion, location and bandwidth will become the mantras of the real estate industry. Connectivity to the Internet will become increasingly important in the Knowledge Age.").

4 Deutsche Bank at 43 ("Small equity investments have been made by office, retail, industrial and multifamily REITs as an initial move to share in the potential of technology/telecom companies. . . . Spin-offs/IPOs are beginning to occur, and we are expecting additional announcements as a means for real estate companies to unlock value for shareholders.").

5 Dain Rauscher Wessels at 113 ("Typically, BSPs target property interests, such as REITs, REOCs, property managers, real estate agents, as well as pension funds and insurance companies that own commercial real estate to form strategic relationships. These relationships have often included BSP warrant issuances to the property interests in exchange for building access rights."); *see also* Deutsche Bank at 43 ("Many revenue-sharing arrangements, especially with telecom service providers, have been formed. Some arrangements include the issuance of warrants to real estate companies."); id. at 47 ("The office real estate companies have entered into many revenue-sharing arrangement with telecom providers to allow access for broadband providers to wire buildings, as tenants' demands for high-speed access are burgeoning.").

6 Only 3% of the office buildings with over 10,000 square feet are wired with broadband access. Deutsche Bank at 87.

involved in telecommunications affects its willingness to permit competitive telecommunications carrier access and the manner in which such access is provided.

Telecommunications analysts agree that building owners are well-positioned to exploit their access-to-tenant bottleneck to capitalize upon developments in the telecommunications industry made possible, in large part, by the Telecommunications Act of 1996.[7] As Deutsche Bank describes it in a recent analyst's report, the real estate industry is the "ultimate portal."[8] Whether and how control over that portal is exercised will affect the development of facilities-based telecommunications competition.

In the short history of building owner involvement in telecommunications, the pattern of behavior has evolved. Many of the earlier arrangements between telecommunications entities and building owners were characterized by granting one carrier exclusive access to the building in exchange for revenue sharing. Exclusive access is perhaps the most egregious form of discrimination against other telecommunications carriers. Although exclusives continue to occur, their prominence gradually is being replaced by more subtle, but equally serious forms of discrimination. This evolution has occurred largely because exclusive arrangements force a building owner to rely too heavily on a single carrier. Exclusive arrangements expose the building owner to risks that the exclusive carrier will fail to serve tenants adequately or will not offer the full panoply of available services. Exclusives also force the building owner to rely too heavily on a single technology. As a result, exclusives are finding some disfavor in the real estate community.

In lieu of exclusives, building owners are entering into revenue sharing agreements with or making equity investments in telecommunications providers.[9] The resulting symbiotic financial relationship motivates the building owner to promote the primacy of its affiliated carrier within the building through exercise of its market power over access to tenants. This objective can be accomplished in several ways. For example, the affiliated carrier can be given the "first-mover advantage."[10] That is, access negotiations with other carriers are delayed or terminated so that the affiliated carrier can become the first competitive carrier to serve the building. Indeed, the affiliated carrier's speed-to-service time is sometimes strictly controlled by the building owner with

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7 These incentives were increased by the recently enacted federal REIT Modernization Act. See Deutsche Bank at 43, 46 ("This legislation gives latitude to real estate management teams to create services and initiatives of value to tenants. From our perspective, RMA is really providing the gateway from which new initiatives that better serve tenants may be launched. The focus for many REITs, initially the office property owners and now multifamily and retail, is wiring their properties for high-speed access, finding the right broadband network solutions to meet their various tenants' needs.").

8 Deutsche Bank at 105-106 ("We consider properties to be the ultimate portals, and the embedded value in real estate is just beginning to be tapped.").

9 Deutsche Bank at 39 ("Office companies are forming alliances with B-LECs, or business-centric local exchange carriers. Revenue-sharing agreements and equity investments in broadband service providers are the rage.").

10 See Goldman Sachs at 12 (explaining that Allied Riser's partnership with 12 leading real estate owners providers "a first mover advantage and a strong barrier to entry.").

potentially negative consequences.[11] In addition, the building owner can recommend and promote the services of the affiliated carrier to tenants above the services of other carriers in the building or can charge access prices to non-affiliated carriers that effectively preclude competitive service to the building.[12] The building owner practices and involvement in telecommunications are not inherently negative and, indeed, may promote competition in telecommunications insofar as discrimination -- which impairs efficient operation of the market and harms consumer welfare -- can be eliminated. Consequently, it is imperative that as building owners become more involved in the provision of telecommunications service (either by providing such service directly or by taking a financial interest in a carrier), a regulatory check be placed on their incentives and abilities to discriminate in favor of carriers with whom they maintain a financial relationship.

We explained that pursuant to the Commission's ancillary jurisdiction, the Commission can require building owners to provide nondiscriminatory telecommunications carrier access to their buildings in order to serve the tenants therein. As an alternative, some parties explained to the Commission in the comment round of this rulemaking that nondiscriminatory access could be accomplished through indirect means.[13] We expanded upon the practical method of implementing this approach where the Commission wished to avoid asserting its jurisdiction directly over building owners.

Specifically, the Commission may prescribe regulations based on the opinion that a practice of a carrier or carriers will violate provisions of the Communications Act.[14] The Commission should conclude that discrimination by a carrier in the form of participating in, cooperating with, or enjoying the benefits of a building owner's decision to prevent tenants from selecting their own

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[11] See Yankee Group at 15 ("Despite the external market pressures, it is the Yankee Group's belief that MBSPs will ultimately face more harm from the property owners with which they have aligned themselves. REITs know very well that their MBSP partners are also securing relationships with many of their competitors (i.e., other REITs). Obviously, it is in a REIT's best interest to ensure that a competitor's building is not lit with services before its own. Subsequently, many property owners are demanding contractual arrangements whereby the MBSP must ensure that services will be turned up *simultaneously* among a specific group of buildings. For property owners, establishing this contractual arrangement ensures that the individual REIT's buildings are turned up at the same time as competitors' buildings. In order to secure valuable real estate, MBSPs are agreeing to such terms. However, the downfall of such arrangements is twofold. First, they require MBSPs to wire buildings in markets that may not be immediately profitable. Second, they require MBSPs to expend significant up-front capital costs across multiple geographic areas. The Yankee Group believes that these factors may have detrimental repercussions for the financial well-being of many MBSPs. We also suspect that some MBSPs may try to work around such restrictions by turning up buildings quickly with minimal capital outlay (i.e., using lower-cost, non-carrier-grade equipment, building less redundancy into their networks, or using leased facilities).").

[12] See Yankee Group at 17 (explaining that Broadband Office's REIT investors recommend BBO's services to tenants and share associated revenues).

[13] See, e.g., "Bringing Telecommunications Competition to Tenants in Multi-Tenant Environments," at 43-48, filed as an attachment to the Comments of the Association for Local Telecommunications Services in the above-referenced proceeding (filed Aug. 27, 1999).

[14] 47 U.S.C. § 205(a).

facilities-based telecommunications carrier is an unjust and unreasonable practice under Section 201(b). A confirmation of this conclusion can be found in the prohibition on carriers' "unjust or unreasonable discrimination in . . . practices . . . for or in connection with like communication service, *directly or indirectly, by any means or device* . . . ."[15] It should then adopt a rule prohibiting telecommunications carriers from participating in, cooperating with, or enjoying the benefits of (*i.e.*, through serving a building) a building owner's decision to prevent tenants from selecting their own facilities-based telecommunications carrier by discriminating against certain telecommunications carriers. A regulation prohibiting cooperation in, or service to a building affected by, discrimination inhibiting subscriber choice can be enforced, *inter alia*, through the Commission's complaint process.[16] In the course of this complaint process, a building owner or manager engaging in discriminatory practices will be a person interested in or affected by the regulation or practice under consideration. As such, the building owner or manager may be joined as a party and subjected to orders issued by the Commission.[17] In such an action, very often the telecommunications carrier will be only a nominal defendant, as was the case in Ambassador, Inc. v. United States.[18] The Commission may aid in the resolution of any dispute by requiring affected carriers to file the contracts they have entered into with building owners whenever complaints are brought before the Commission.[19]

This process was approved by the Supreme Court in the 7-0 Ambassador decision. In that case, the underlying issue involved the protection of consumers in hotels and apartment buildings. Just as with building access in the *Competitive Networks* rulemaking, the Court recognized that telephone service was indispensable to the hotels that were parties defendants. The Court also recognized that the hotel-provided services in issue imposed some additional costs on the hotels.

The Commission, after hearing, entered an order requiring the telephone companies to include appropriate terms in their tariffs. While the Commission gave the telephone companies a choice of either specifying the actual mark-up prices charged by the hotels or limiting what the hotels could do as subscribers of the service, the important point was that under either approach, the Commission thenceforth would be able to regulate efficiently. It is clear that the Commission can proceed either by tariff prescription or by general regulation.[20]

The Supreme Court explained that "[o]f course, such authority is not unlimited. The telephone companies may not, in the guise of regulating the communications service, also regulate the hotel or apartment house or any other business. But where a part of the subscriber's business

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15 47 U.S.C. § 202(a)(emphasis added).

16 47 U.S.C. § 208.

17 47 U.S.C. § 411(a).

18 325 U.S. 317 (1945).

19 47 U.S.C. § 211(b).

20 47 U.S.C. § 205(a).

consists of retailing to patrons a service dependent on its own contract for utility service, the regulation will necessarily affect, to that extent, its third party relationships."[21] Section 411(a) was properly applied to join the hotels as parties defendant, and the Court concluded that an injunction against the hotels was appropriate under Section 411(a) even though no injunction issued against the telephone companies.[22] Enclosed as Attachment 2 are copies of the parties' Supreme Court briefs in this case (along with a brief summary thereof) for the meeting participants' review.

As far as we have been able to discern, *Ambassador* represents the entirety of judicial consideration of Section 411(a). The provision is derived from an analogous provision in the Interstate Commerce Act.[23] Judicial interpretations of the Interstate Commerce Act provision lend additional support to the conclusion of the *Ambassador* Court that the joinder provisions give the regulatory agency the authority to impose judgments against non-carriers in appropriate circumstances.[24] This is consistent with the recognition by many States that a bottleneck controlled by an unregulated entity between a carrier and a consumer can prevent efficient operation of the market and impair realization of policy goals. In response, these States enacted requirements ensuring tenant access to their carrier of choice, as outlined in a letter from Philip Verveer to Kathryn Brown, filed with the Secretary as an ex parte submission in the above-referenced proceedings by the Smart Buildings Policy Project on Thursday, July 27th, a copy of which was provided to yesterday's meeting participants.

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21 Ambassador, Inc., 325 U.S. at 323-24. A copy of the decision was provided to participants of yesterday's meeting.

22 Id. at 325-26.

23 See S. Rep. No. 781, 73d Cong., 2d Sess., at 10 (1934)("Section 411 carries forward provisions of the Elkins Act and of section 16(4) of the Interstate Commerce Act relating to joinder of parties and payment of money."). The analogous provision of the Interstate Commerce Act is now found at 49 U.S.C. § 42.

24 See, e.g., United States v. Baltimore & O.R. Co., 333 U.S. 169, 171 n.2 (jurisdiction over stock yard practices); see id. at 177 ("Of course it does not deprive an owner of his property without due process of law to deny him the right to enforce conditions upon its use which conflict with the power of Congress to regulate railroads so as to secure equality of treatment of those whom the railroads serve."); see also United States v. City of Jackson, Mississippi, 318 F.2d 1, 16-19 (5th Cir. 1963)(enjoining sheriff's enforcement of racially segregated waiting areas in railroad and bus terminals, and citing to the extensive use of Section 42 of the Interstate Commerce Act to enjoin the practices of non-carriers).

Because these topics concern a pending rulemaking at the Commission, in accordance with the Commission's rules, for each of the above-mentioned proceedings, I hereby submit to the Secretary of the Commission two copies of this notice of the Smart Buildings Policy Project's ex parte presentation.

Respectfully submitted,

Philip L. Verveer

Counsel for the
SMART BUILDINGS POLICY PROJECT

Enclosures

cc: Thomas Sugrue (WTB)
Lauren Van Wazer (WTB)
Paul Noone (WTB)
Jeffrey Steinberg (WTB)
Joel Taubenblatt (WTB)
Richard Arsenault (WTB)

March 30, 2000

CYPRESS COMMUNICATIONS INC (CYCO)

Annual Report (SEC form 10-K)

Management's Discussion And Analysis Of Financial Condition And Results Of Operations

Overview

We provide a full range of broadband communications services to small and medium-sized businesses located in multi-tenant office buildings in major metropolitan markets in the United States. This comprehensive bundle of services currently includes high speed dedicated Internet access, local and long distance voice services, digital telephone systems, business television, voicemail, e-mail, web hosting and other advanced services. Since the inception of our predecessor company in August 1995, our principal activities have included securing license agreements with building owners and real estate managers that enable us to install our in-building fiber-optic, digital and broadband networks, marketing our communications services to tenants and hiring qualified personnel to support our rapid growth. We began operating in-building networks in June 1996 and as of December 31, 1999, we were providing services in 116 buildings representing approximately 30 million rentable square feet. As of December 31, 1999, we had secured agreements giving us the right to operate our networks in over 730 buildings representing more than 229 million rentable square feet.

Building and expanding our business will continue to require us to incur significant capital expenditures. These expenditures will consist primarily of purchases of communication equipment and construction costs associated with building our in-building networks. We attempt to maximize the benefit of deployed capital by investing in network assets only after entering into a long- term license agreement with a property owner. In addition, capital is not expended on a customer until we have a signed contract with that customer. As a result, a large portion of our capital expenditures is success-based. In a typical

335,000 square foot building, up-front capital investment is usually less than $90,000 which includes the purchase and installation of our in- building vertical communications infrastructure, commonly known as a riser system, and associated network equipment. As we begin to successfully penetrate a building, in order to provide additional network capacity and equipment for our customers, capital deployment in that building may grow to over $335,000.

We have experienced operating losses and generated negative adjusted EBITDA, as defined in "Selected Financial Data," and expect to continue to generate losses and negative adjusted EBITDA for the foreseeable future while we continue to construct in-building networks, expand our customer base and build our internal infrastructure. As a result of our limited operating history, prospective investors have limited operating and financial data upon which to evaluate our performance.

Factors Affecting Future Operations

Revenue. We generate revenue from selling data, voice and other services and from the rental of telephone systems and other equipment to tenants in the buildings in which we own and operate networks. The majority of our revenue is generated on a monthly recurring basis. The remainder of our revenue is derived from non-recurring charges for installations and other one-time services. Our customer contracts typically range between one and seven years in length and are usually designed to coincide with our customers' office space leases. The typical length of our customer contracts is three years.

We believe that our ability to generate revenue in the future will be affected primarily by the following factors, some of which we cannot control:

. our ability to enter into license agreements with building owners and install our in-building networks;

. our ability to obtain customers before our competitors do;

. the level of competition we face from other communications providers, including price competition, which has resulted in a trend of declining prices and margins for communications services over time;

. the demand for our services; and

. possible regulatory changes, including regulations requiring building owners to give access to competitive providers of communications services.

Cost of services. Cost of services consists primarily of leased transport charges, which are lease payments to communications providers for the transmission facilities used to connect our in-building networks to incumbent local telephone companies' and other competitive local and long distance carriers' networks. Other costs include per minute charges paid to long distance providers for use of their networks, monthly fees paid to Internet providers, equipment maintenance expenses, and labor costs associated with installing equipment and changing customers' services. We expect these costs to increase in aggregate dollar amount as we continue to grow our business but to decline as a percentage of revenue due to economies of scale, expected improvements in technology and price competition from an increased number of vendors from which we can lease voice and data transport. However, in markets where there is only a single carrier, or only a limited number of carriers, available to provide sufficient transmission capacity, the cost of services may actually increase.

Sales and marketing expenses. Sales and marketing expenses include applicable employee salaries and commission payments and marketing, advertising and promotional expenses. Sales and marketing expenses also include the amortization of deferred compensation which is a result of our granting stock options to sales and marketing employees with exercise prices per share treated for accounting purposes as below the fair value of our common stock at the dates of grant. We are amortizing the deferred compensation over the vesting period of the applicable option, which is generally five years. We recognized amortization of deferred compensation expense related to sales and marketing employees of $19,248 and $321,492 for the years ended December 31, 1998 and 1999, respectively (See Note 4 to our financial statements). Sales and marketing expenses also include payments to building owners and operators under license agreements, as described below.

In November and December 1999, we entered into master license agreements with several owners and operators of office buildings. Each master license agreement sets forth a list of buildings owned or managed by the property owner or operator that is a party to that agreement. In accordance with the terms of these agreements, we have begun to enter into property-specific license agreements with respect to each listed building. In some cases, the property owner or operator may need to obtain consent from third parties who may have an ownership interest in the building before we can enter into a property-specific license agreement for that building. Under the property-specific license agreements, the property owner or operator will grant us a license to install and operate our networks in each building in return for approximately 6% of the revenue we receive from tenants in that building. The initial term of each property-specific license agreement is generally five years, with an automatic five year extension at the end of the initial term, absent any default under the agreement. These master license agreements gave us the right to operate our networks in more than 600 buildings representing more than 194 million rentable square feet.

In addition to the master license agreements, we also have license agreements with a number of other property owners and operators which were previously executed on a per building basis. Under these agreements, we have agreed to pay property owners either a base fee or a percentage fee of between 3% and 6% of our revenue in the building. As of December 31, 1999, our aggregate minimum obligation under these agreements was approximately $130,000 per year for the next seven years.

We expect to incur significant sales and marketing expenses as we continue to grow our business and build our brand.

General and administrative expenses. General and administrative expenses include costs associated with the recruiting and compensation of corporate administration, customer care and technical services personnel as well as costs of travel and entertainment, back office systems, and legal, accounting and other professional services. These costs are expected to increase significantly as we expand our operations, but decline over time as a percentage of revenue due to economies of scale. General and administrative expenses also include the amortization of deferred compensation which is a result of our granting stock options to general and administrative employees with exercise prices per share treated for accounting purposes as below the fair value of our common stock at the dates of grant. We are amortizing the deferred compensation over the vesting period of the applicable option, which is generally five years. We recognized amortization of deferred compensation expense related to general and administrative employees of $98,345 and $1,403,796 for the years ended December 31, 1998 and 1999, respectively (See Note 4 to our financial statements).

Depreciation and amortization. Depreciation and amortization expenses include depreciation of network related equipment, information systems, furniture, fixtures, leasehold improvements and the amortization of goodwill and acquired tenant contracts.

In connection with the execution of master license agreements in November and December 1999, we also entered into stock warrant agreements with the same property owners and operators. Under the terms of these agreements, we issued these owners and operators warrants to purchase an aggregate of 11,163,990 shares of our common stock at an exercise price of $4.22 per share. The exact number of shares of common stock underlying the warrants, which is based on the gross leasable area of the buildings set forth in the master license agreements, will be determined upon the completion of due diligence and the finalization of the building construction schedules, which is expected to be completed in April 2000. The measurement date for valuing the warrants will be the date(s) on which the property owners or managers effectively complete their performance requirements (see Note 4 to our financial statements).

Based upon the current structure of the agreements governing the warrants, we expect that the fair value of the warrants will approximate $170 million and will be capitalized as license inducement expense and amortized over the applicable terms of the license agreements with property owners and operators. Such license terms are generally 10 years. Depending on the prevailing fair market value of the warrants at the measurement date, the amount of license inducement and related amortization may change and such change could be material. In addition, we could incur additional cash or non-cash charges as license inducements to current or future property owners, and such amounts may be material.

We expect depreciation and amortization expenses to increase significantly as we enter into additional property license agreements and install our networks in more buildings.

Acquisition strategy. We intend to opportunistically pursue acquisitions or other strategic relationships to expand our customer base or geographic presence. These activities could significantly impact our results of operations and require us to raise additional capital earlier than expected.

In November 1999 we entered into a binding letter of intent to acquire approximately 18% of the common stock of SiteConnect, a Seattle-based in- building communications service provider, in exchange for 281,250 shares of our common stock. The agreement gives us a one-year option to purchase the remaining outstanding shares of common stock of SiteConnect for approximately $5.0 million of our common stock, valued at the initial public offering price, which would be 294,118 shares based on the initial public offering price of $17.00 per share. Currently, SiteConnect provides data communications services to customers in ten commercial office buildings in Seattle.

Results of Operations

Year Ended December 31, 1999 Compared to the Year Ended December 31, 1998

Revenues. Revenues for the year ended December 31, 1999 increased 208% to $7.4 million from $2.4 million for the same period in the prior year. $3.2 million of the increase in revenues relates to the addition of new customers and providing additional services to existing customers. $1.8 million of the increase relates to the acquisition of the assets and customers of MTS Communications Company in December 1998 (see Note 9 to our financial statements).

Cost of services. Cost of services for the year ended December 31, 1999 increased 223% to $5.0 million from $1.5 million for the same period in the prior year. The increase in cost of services was due to an increase in the number of leased facilities connecting our licensed buildings to local, long distance and Internet providers and the greater volume of voice and data traffic. As of December 31, 1999, we had networks installed in 116 buildings versus 39 buildings installed at December 31, 1998.

Sales and marketing expenses. Sales and marketing expenses for the year ended December 31, 1999 increased 169% to $4.0 million from $1.5 million for the same period in the prior year. $1.8 million of this increase in expenses was due to an increase in the number of sales and marketing personnel and their related compensation and expenses; $0.3 million of this increase was due to non-cash compensation related to the issuance of stock options at exercise prices lower than fair market value on their dates of grant (see Note 4 to our financial statements); $0.2 million of this increase was due to increased revenue sharing payments made to property owners with whom we have license agreements; and $0.2 million of this increase was due to increased promotion of our services via direct marketing and advertising in our licensed buildings. The decrease in sales and marketing expenses as a percentage of revenue related primarily to the additional revenue attributable to the acquisition of the assets of MTS Communications without a comparable increase in sales and marketing expenses. We expect sales and marketing expenses to continue to grow as we hire additional personnel and incur additional expenses to market our services to potential customers.

General and administrative expenses. General and administrative expenses for the year ended December 31, 1999 increased 343% to $11.2 million from $2.5 million for the same period in the prior year. The increase in general and administrative expenses was due primarily to a $4.5 million increase in salaries, benefits and recruiting expenses related to the hiring of additional personnel, a $1.3 million increase in non-cash compensation related to the issuance of stock options at exercise prices lower than fair value on their dates of grant (see Note 4 to our financial statements), a $0.5 million increase in travel and entertainment expenses primarily related to marketing to property owners and operators and expenses associated with personnel traveling to oversee and conduct the installation of our networks in additional buildings, a $0.6 million increase in accounting, consulting, legal and billing outsourcing fees, and a $1.8 million increase in office space rent and other growth-driven operating expenses. We expect general and administrative expenses to continue to grow as we hire additional personnel and incur additional expenses to support the growth of our operations.

Depreciation and amortization. Depreciation and amortization for year ended December 31, 1999 increased 281% to $2.2 million from $0.6 million for the same period in the prior year. $1.0 million of this increase was due to increased capital expenditures related to deploying our in-building networks and related equipment; $0.4 million of this increase was attributable to the acquisition of the assets of MTS Communications (see Note 9 to our financial statements); $0.1 million of this increase was due to depreciation of computers and other back-office equipment; and $0.1 million of this increase was due to amortization of goodwill and tenant contracts related to the acquisition of MTS Communications (see Note 9 to our financial statements).

Interest income, net. Interest income, net for the year ended December 31, 1999 increased to $810,045 from $232,279 for the same period in the prior year. The increase in interest income, net was due to

increased investments in short-term interest bearing investments as a result of investing the proceeds raised from our Series B preferred stock offering in September 1998 and our Series C preferred stock offering in the third quarter of 1999 (see Note 5 to our financial statements). Interest expense was nominal in both periods.

Year Ended December 31, 1998 compared to the Year Ended December 31, 1997

Revenues. Revenues for the year ended December 31, 1998 increased 241% to $2.4 million from $0.7 million for the same period in the prior year. $1.6 million of the increase was the result of the addition of new customers and the provision of additional services to existing customers. $89,805 of the increase was attributable to the acquisition of the assets and customers of MTS Communications in December 1998 (see Note 9 to our financial statements).

Cost of services. Cost of services for the year ended December 31, 1998 increased 155% to $1.5 million from $0.6 million for the same period in the prior year. The growth in cost of services was the result of providing services to an increased number of customers and an increase in the number of leased facilities connecting our licensed buildings to local, long distance and Internet providers. As of December 31, 1998, we had networks installed in 39 buildings versus 19 buildings at December 31, 1997.

Sales and marketing expenses. Sales and marketing expenses for the year ended December 31, 1998 increased 232% to $1.5 million from $448,916 for the same period in the prior year. $0.9 million of this increase in expenses was due to an increase in the number of sales and marketing personnel and their related compensation and expenses; $80,429 of this increase was due to increased revenue sharing payments made to property owners with whom we have license agreements; and $40,720 of this increase was due to increased promotion of our services via direct marketing and advertising in our licensed buildings. We expect sales and marketing expenses to continue to grow as we hire additional personnel and incur additional expenses to market our services to potential customers.

General and administrative expenses. General and administrative expenses for the year ended December 31, 1998 increased 181% to $2.5 million from $.9 million for the same period in the prior year. The increase in general and administrative expenses was due primarily to a $1.0 million increase in salaries, benefits and recruiting expenses related to the hiring of additional personnel, a $0.1 million increase in non-cash compensation related to the issuance of stock options at exercise prices lower than fair value on their dates of grant (see Note 4 to our financial statements), a $0.1 million increase in accounting, consulting, legal and billing outsourcing fees, and a $0.4 million increase in office space rent, travel and other growth-driven operating expenses. We expect general and administrative expenses to continue to grow as we hire additional personnel and incur additional expenses to support the growth of our operations.

Depreciation and amortization. Depreciation and amortization for the year ended December 31, 1998 increased 194% to $576,659 from $196,415 for the same period in the prior year. $285,645 of this increase was due to increased capital expenditures related to deploying our in-building networks and related equipment; $32,766 of this increase was attributable to the acquisition of the assets of MTS Communications (see Note 9 to our financial statements); $49,181 of this increase was due to depreciation of computers and other back-office equipment; and $12,652 of this increase was due to amortization of goodwill and tenant contracts related to the acquisition of MTS Communications (see Note 9 to our financial statements).

Interest income, net. Interest income, net for the year ended December 31, 1998 increased 104% to $232,279 from $113,922 for the same period in the prior year. The increase in interest income, net was due to increased investments in short-term interest bearing investments as a result of investing the proceeds raised from our series A preferred stock offering in July 1997 and our series B preferred stock offering in September 1998 (see Note 5 to our financial statements). Interest expense was nominal in both periods.

Liquidity and Capital Resources

The results of our operations have generated a net cash outflow due to the rate at which we have grown. Cash flow from operations totaled $(891,519), $(2.9 million), and $(9.9 million) for the years ended, December 31, 1997, 1998, and 1999, respectively. The expansion of our operating and administrative personnel, office space costs, and other operating expenses were the principal contributors to the increases in the net cash outflow between the periods. As we continue to expand our operations, these increases in period-over-period operating cash outflows will continue.

Cash used in investing activities was ($1.2 million), $(5.0 million), and $(10.1 million) for the years ended December 31, 1997, 1998, and 1999, respectively. Cash used in investing activities has primarily been used to build-out our in-building networks. In 1998 we used $1.9 million to purchase the assets of MTS Communications. As of December 31, 1999, we had made capital expenditures of $15.0 million since inception. We expect that capital expenditures will increase substantially in future periods as we construct our networks and purchase more communications equipment. We will continue to seek access to additional buildings. If we are successful in gaining access to additional buildings, we will have substantial needs for additional capital for an indefinite period. We also expect to have substantial and increasing negative adjusted EBITDA and net losses.

Cash provided by financing activities was $5.3 million, $15.3 million and $78.5 million for the years ended December 31, 1997, 1998, and 1999, respectively. Financing has primarily been obtained through the issuance of convertible preferred stock to private investors (See Note 10 to our financial statements). The proceeds from these equity issuances have been and will continue to be used to fund cash outflows for operating and investing activities.

On December 8, 1998, we acquired certain assets of MTS Communications, a provider of communications services in California, for total consideration of $2,574,848 consisting of $1,904,398 in cash and the assumption of certain capital lease obligations with a fair value of $670,450. In November 1999, we signed a binding letter of intent to acquire 254,125 shares of common stock, representing less than 20% common stock ownership, of SiteConnect, Inc., a Seattle-based provider of communication services, for consideration of 281,250 shares of our common stock. The agreement contains an option to purchase the remaining outstanding common stock of SiteConnect for approximately $5.0 million of our common stock valued at the initial public offering price, which would be 294,118 shares based on the initial public offering price of $17.00 per share.

In November and December 1999, we issued warrants to purchase an aggregate of 11,163,990 shares of our common stock at an exercise price of $4.22 per share to several property owners and operators who executed master license agreements. The exact number of shares of common stock underlying the warrants, which is based on the gross leasable area of the buildings set forth in the master license agreements, will be determined upon the completion of due diligence and the finalization of the building schedules, which is expected to be completed in April 2000. These master license agreements gave us the right to operate our networks in more than 600 buildings representing more than 194 million rentable square feet. As noted above, on a typical 335,000 square foot building, the up front capital investment is usually less than $90,000. As we begin to successfully penetrate a building, our capital deployment may grow to over $335,000.

As of December 31, 1999, we had minimum payment obligations under existing license agreements of approximately $130,000 per year for the next seven years.

As of December 31, 1999, we had $577,677 in capital lease obligations outstanding (including interest and taxes associated therewith). The majority of these capital lease obligations were assumed through the acquisition of the assets of MTS Communications. Our capital lease obligations contain no provisions that would limit its future borrowing ability.

We currently have contracts with several communications providers under which we have minimum purchase obligations for leased transport. As of December 31, 1999, these minimum purchase obligations totaled approximately $1.6 million through 2001. We will have to pay those providers even if these services are not utilized.

On February 15, 2000, we completed our initial public offering of common stock, raising net proceeds of approximately $179 million. We intend to use approximately $100.0 million of the net proceeds from this offering for construction of in-building networks and the purchase of communications equipment and approximately $10.0 million for implementation and modification of information support systems; however, we currently have no material purchase commitments with respect to these planned expenditures. The remainder of the net proceeds will be available for working capital and general corporate purposes. We may also use a portion of the net proceeds to acquire or invest in complementary businesses, technologies, services or products. However, we currently have no material commitments or agreements with respect to any of these types of transactions.

We are currently operational in 17 markets, and plan to expand our presence to approximately 27 markets by the end of 2000 and approximately 40 markets by the end of 2001. We estimate that this expansion will require capital expenditures of approximately $50.0 million in 2000 and approximately $90.0 million in 2001.

We estimate that the net proceeds of this offering in addition to cash on hand will be sufficient to fund operations and the projected deployment of our network through mid-2001. We do, however, expect to continue our growth, expansion and the further development of our network and services beyond that point. Accordingly, we expect that we will eventually need to arrange for additional sources of capital through the issuance of debt or equity or bank borrowings. There are no commitments for any such additional financing, and we cannot be sure that we will be able to obtain any such additional financing at the times required and on acceptable terms and conditions. In such event, our growth could slow and operations could be adversely affected.

The actual amount and timing of our future capital requirements may differ materially from our estimates as a result of many factors, some of which we cannot control. These factors include:

. the timing of execution of license agreements; . the ability to meet or exceed construction schedules; . obtaining favorable prices for purchases of equipment; . our ability to develop, acquire and integrate the necessary operational support systems; . the cost of network development in each of our markets; . demand for our services; . the nature and penetration of new services that may be offered by the us; . the timing and extent of future acquisitions or investments, if any, and our ability to integrate these acquisitions or investments; . regulatory changes; and . changes in technology and competitive developments beyond our control.

Recent Accounting Pronouncements

The Securities and Exchange Commission has released SAB No. 101, "Revenue Recognition in Financial Statements." We are reviewing our policies with respect to SAB No. 101 and do not anticipate the impact of adoption to be material.

Year 2000 Compliance

The Year 2000 issue is the result of computer-controlled systems using two digits rather than four to define the applicable year. For example, certain computer programs that have time-sensitive software may recognize a date ending in "00" as the year 1900 rather than the year 2000. This could result in system failure or miscalculations causing disruptions of operations including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities.

As of March 30, 2000, we have not experienced any material problems as a result of the Year 2000 issue. Costs to ensure that our systems and networks are Year 2000 compliant have not been, and are not expected to be, material.

RISK FACTORS THAT MAY AFFECT FUTURE RESULTS

We expect our losses to continue to increase for the foreseeable future

Since our formation we have generated increasing negative adjusted EBITDA, as defined in "Selected Financial Data," and larger net losses each quarter. We have not achieved profitability and expect to continue to incur increasing negative adjusted EBITDA and larger net losses for the foreseeable future. For 1998, we had adjusted EBITDA of $(3,028,358) and a net loss of $(3,490,331) on revenues of $2,417,816. For 1999, we had adjusted EBITDA of $(11,043,206) and a net loss of $(14,156,280) (excluding a non-recurring charge related to the beneficial conversion feature of the preferred stock) on revenues of $7,437,496. In addition, we expect to continue to incur significant costs as we deploy additional in-building networks and, as a result, we will need to generate significant revenue to achieve profitability, which may not occur.

Our business has grown rapidly and our business model is still evolving, which makes it difficult to evaluate our prospects

We have grown our business rapidly and have experienced significant losses in our efforts to penetrate our market. We will continue to make substantial capital expenditures in deploying our networks before we know whether our business plan can be successfully executed. As a result, there is a risk that our business will fail. Additionally, our limited operating history makes it difficult to evaluate the execution of our business model thus far. Furthermore, because the market for services of in-building communications providers is not well established, it is difficult for you to compare our company with our competitors.

We are an early-stage company in an unproven industry and if we do not grow rapidly or obtain additional capital we will not succeed

We began operating our first in-building network in June 1996 and were operating 116 in-building networks as of December 31, 1999. We must, however, continue to grow rapidly in order to succeed. Because the communications industry is capital intensive, rapidly evolving and subject to significant economies of scale, as a relatively small organization we are at a competitive disadvantage. The growth we must achieve to reduce that disadvantage will put a significant strain on all of our resources. Our current capital resources, including our cash on hand, will be sufficient to fund our operations and the projected deployment of additional in-building networks only through mid-2001. We will require substantial additional capital beyond

then to finance our future operations according to our current business plan. If we fail to grow rapidly or obtain additional capital, we may not be able to compete with larger, more well-established companies.

Additionally, we are unaware of any industry studies which have specifically addressed the market for services of in-building communications providers. The demand for bundled services from in-building communications providers is unproven and may grow less than the demand for communications services generally, or not at all. Furthermore, our own growth rate may not match the growth rate of the in-building communications market as a whole.

Our business plan cannot succeed unless we continue to obtain license agreements with building owners and managers

Our business depends upon our ability to install in-building networks. The failure of building owners or managers to grant or renew access rights on acceptable terms, or any deterioration in our existing relationships with building owners or managers, could harm our marketing efforts and could substantially reduce our potential customer base. Current federal and state regulations do not require building owners to make space available to us, or to do so on terms that are reasonable or nondiscriminatory. Building owners or managers may decide not to permit us to install our networks in their buildings or may elect not to renew our license agreements. Non-renewal of these agreements would reduce our revenues and we might not recover all of our infrastructure costs.

We must place our network infrastructures in additional buildings before our competitors do or we will face a substantial competitive disadvantage

Our success will depend upon our ability to quickly obtain license agreements and install our in-building networks in many more buildings. This is crucial in order to establish a first-mover advantage. We may not be able to accomplish this. Each building in which we do not build a network is particularly vulnerable to competitors. In addition, future expansions and adaptations of our network infrastructures may be necessary to respond to growth in the number of customers served, increased capacity demands and changes to our services; otherwise other companies could be encouraged to compete in buildings where we have installed networks.

In addition, future expansion will require us to outsource a significant portion of the installation of our in-building networks. Any delays in obtaining, or interruption in, the services of these third party installers could delay our plans to install in-building networks, impair our ability to acquire or retain customers and harm our business generally.

We may not be able to efficiently manage our growth, which could harm our business

Future expansion will place significant additional strains on our personnel, financial and other resources. The failure to efficiently manage our growth could adversely affect the quality of our services, our business and our financial condition. Our ability to manage our growth will be particularly dependent on our ability to develop and retain an effective sales force and qualified technical and managerial personnel. The competition for qualified sales, technical and managerial personnel in the communications industry is intense, and we may not be able to hire and retain sufficient qualified personnel. In this regard, we note that we do not have employment contracts with our key personnel. In addition, we may not be able to maintain the quality of our operations, to control our costs, to maintain compliance with all applicable regulations, and to expand our internal management, technical, information and accounting systems in order to support our desired growth.

Our business will be harmed if our information support systems are not further developed

Sophisticated information processing systems, including billing, are vital to our growth and our ability to achieve operating efficiencies. A failure of these systems could substantially impair our ability to provide services, send invoices and monitor our operations. Among the systems we have identified as being presently inadequate to meet the increased demands of our anticipated growth are work-flow and customer priority management, human resources, sales and customer support and fixed asset management, and there may be other systems we have not identified that are in need of improvement. We estimate that modifying or replacing these systems will cost approximately $10 million in fiscal year 2000. Our plans for the development and implementation of these systems rely largely upon acquiring products and services offered by third-party vendors and integrating those products and services. We may be unable to implement these systems on a timely basis or at all, and these systems may not perform as expected. We may also be unable to maintain and upgrade our operational support systems as necessary.

We operate in a highly competitive market, and we may not be able to compete effectively against established competitors with greater financial resources and diverse strategic plans

We face competition from many communications providers with significantly greater financial resources, well-established brand names, larger customer bases and diverse strategic plans and technologies. Intense competition has led to declining prices and margins for many communications services. We expect this trend to continue as competition intensifies in the future. We expect significant competition from traditional and new communications companies, including local, long distance, cable modem, Internet, digital subscriber line, fixed and mobile wireless and satellite data service providers, some of which are described in more detail below. If these potential competitors successfully focus on our market, we may face intense competition which could harm our business. In addition, we may also face severe price competition for building access rights, which could result in higher sales and marketing expenses and lower profit margins.

We face competition from other in-building communications providers

Some competitors, such as Allied Riser Communications, Broadband Office and OnSite Access, are attempting to gain access to office buildings in our target markets. To the extent these competitors are successful, we may face difficulties in building our networks and marketing our services within some of our target buildings. Because our agreements to use utility shaft space within buildings are generally not exclusive, owners of such buildings could also give similar rights to our competitors. Certain competitors already have rights to install networks in some of the buildings in which we have rights to install our networks. It is not clear whether it will be profitable for two or more different companies to operate networks within the same building. Therefore, it is critical that we build our networks in our target buildings quickly, before our competitors do so. If a competitor installs a network in a building in which we operate, there will likely be substantial price competition.

We face competition from local telephone companies

Incumbent local telephone companies, including GTE and regional Bell operating companies such as Bell Atlantic and BellSouth, have several competitive advantages over us, including established brand names and reputations and significant capital to rapidly deploy or leverage existing communications equipment and broadband networks. They often market their services to tenants of buildings within our target markets and selectively construct in-building facilities. Additionally, the regional Bell operating companies are now permitted to provide long distance services in territories where they are not the dominant provider of local services. These companies may also provide long distance services in the territories where they are the dominant provider of local services if they satisfy a regulatory checklist established by the Federal Communications Commission. In December 1999, the FCC ruled that Bell Atlantic has met these requirements in New York and may provide long distance services in New York. If other regional Bell operating companies are permitted to provide long distance services in territories where we operate, we could face greater price competition.

We face competition from long distance companies

We will face strong competition from long distance companies. Many of the leading long distance carriers, including AT&T, MCI WorldCom and Sprint, could begin to build their own in-building voice and data networks. The newer national long distance carriers, such as Level 3, Qwest and Williams Communications, are building and managing high speed fiber-based national voice and data networks, partnering with Internet service providers, and may extend their networks by installing in-building facilities and equipment.

We face competition from fixed wireless service providers

We may lose potential customers to fixed wireless service providers. Fixed wireless service providers are communications companies who can provide high speed communications services to customers using microwave or other facilities or satellite earth stations on building rooftops. Some of these providers have targeted small and medium-sized business customers and have a business strategy that is similar to ours. These providers include Advanced Radio Telecom, NEXTLINK and Winstar.

We face competition from Internet service providers, digital subscriber line companies and cable-based service providers

The services provided by Internet service providers, digital subscriber line companies and cable-based service providers could be used by our potential customers instead of our services. Internet service providers, such as Concentric Networks, EarthLink and PSINet, provide Internet access to residential and business customers, generally using the existing communications infrastructure. Digital subscriber line companies and/or their Internet service provider customers, such as Covad, NorthPoint and Rhythms NetConnections, typically provide broadband Internet access using digital subscriber line technology, which enables data traffic to be transmitted over standard copper telephone lines at much higher speeds than these lines would normally allow. Cable-based service providers, such as Excite@Home and its @Work subsidiary, RCN Telecom Services and Road Runner, also provide broadband Internet access. These various providers may also offer traditional or Internet-based voice services to compete with us.

Competitors might use new or alternative technologies to offer better or less expensive services than we can offer

In addition to the fiber-optic technology that our networks employ, there are other technologies that provide greater bandwidth than traditional copper wire transmission technology and may be used instead of our voice and data services. Furthermore, these technologies may be improved and other new technologies may develop that provide greater bandwidth than the fiber-optic based technology we utilize. Existing alternative technologies include:

. Digital Subscriber Line Technology. Digital subscriber line technology was developed to produce higher data transfer rates over the existing copper- based telephone network. The data transfer rates for digital subscriber lines are reported to range between 144,000 bits of data per second and six million bits of data per second.

. Cable Modems. Cable modems can allow users to send and receive data using cable television distribution systems. According to industry sources, cable modem users typically experience download speeds of 1.5 million bits of data per second.

. Wireless Technologies. Wireless technologies, such as satellite and microwave communications systems, can provide high speed data communications. Satellite systems, such as DirecPC, can offer high download speeds that are advertised at 400,000 bits of data per second or higher.

. Integrated Services Digital Networks. Integrated services digital networks have been offered by the incumbent local telephone companies over the existing copper-based telephone network for some time. These services offer data transfer speeds of 128,000 bits of data per second.

. Internet Telephony. Several competitors have deployed, and others are developing, Internet telephony, whereby voice calls may be made over the Internet. The sound quality of these services has improved since their introduction.

The development of new technologies or the significant penetration of alternative technologies into our target market may reduce the demand for our services and harm our business.

Legislation and government regulation could adversely affect us

Many of our services are subject to federal, state and/or local regulation. As we continue to expand our operations geographically, we will become subject to the regulation of additional jurisdictions. If we fail to comply with all applicable regulations or experience delays in obtaining required approvals, our business could be harmed. For example, we must make regular filings in some of the states in which we operate and could be fined if we do not timely make these filings. Additionally, compliance with these regulatory requirements may be costly. Regulations governing communications services also change from time to time in ways that are difficult to predict. Such changes may harm our business by increasing competition, decreasing revenue, increasing costs or impairing our ability to offer services. For example, the FCC could mandate that building owners give access to competitive providers of communications services.

If our interpretation of regulations applicable to our operations is incorrect, we may incur additional expenses or become subject to more stringent regulation

Some of the jurisdictions where we provide services have little, if any, written regulations regarding our operations. In addition, the written regulations and guidelines that do exist in a jurisdiction may not specifically address our operations. If our interpretations of these regulations and guidelines is incorrect, we may incur additional expenses to comply with additional regulations applicable to our operations.

Regulation of access to office buildings could negatively affect our business

There have been proposals to require that commercial office buildings give access to competitive providers of communications services, and some states, such as California and Texas, already have similar laws. Regulatory or legal requirements that mandate access rights to our target buildings or our networks would facilitate our competitors' entry into buildings where we have access rights. Our competitors' access to buildings in which we operate could diminish the value of our access rights to that property and adversely affect our competitive position. Increased access would be particularly detrimental in buildings in which we currently have exclusive or semi-exclusive access rights. Recently, the FCC initiated a regulatory proceeding relating to utility shaft access in multiple tenant buildings, and a bill was introduced in Congress regarding the same topic. Some of the issues being considered in these developments include requiring building owners to provide utility shaft access to communications carriers, and requiring some communications providers to provide access to their wiring to other communications providers. We do not know whether or in what form these proposals will be adopted.

We must purchase voice and data transmission capacity from third parties who may be unable or unwilling to meet our requirements

We rely upon other communications carriers, such as local telephone companies, long distance companies and Internet service providers, to provide transmission capacity from the buildings we serve. Our failure to obtain adequate connections from other carriers on a timely basis could delay or impede our ability to

provide services and generate revenue. We have experienced, and expect to continue to experience, delays in obtaining transmission capacity. In addition, in some of our target markets there is only one established carrier available to provide the necessary connection. This increases our cost and makes it extremely difficult, if not impossible, to obtain sufficient backup, or redundant, connections. Sufficient capacity or redundant capacity may not be readily available from third parties at commercially reasonable rates, if at all. Our failure to obtain sufficient redundant connectivity could result in an inability to provide service in certain buildings and service interruptions, which could in time lead to loss of customers and damage to our reputation. Additionally, many of the communications carriers we rely on for transmission capacity are also our direct competitors. See "We operate in a highly competitive market, and we may not be able to compete effectively against established competitors with greater financial resources and diverse strategic plans."

We rely on local telephone companies for transmission capacity

As noted above, we rely on local telephone companies for transmission capacity. The rates we pay to the local telephone companies are generally approved by the regulatory agency with jurisdiction over that carrier. Local telephone companies may try to modify the terms under which they provide us services to make it more difficult or more costly for us to provide services to our tenants. Changes to the rates that local telephone companies charge us may prevent us from providing services to our tenants at rates that are competitive and profitable. Further, local telephone companies may not provide us access to their network facilities in a prompt and efficient manner.

We rely on long distance providers for transmission capacity

We also rely on long distance providers for transmission capacity. The rates that we pay these providers have generally been decreasing over time. These rates may, however, rise in the future as a result of changes in regulation or otherwise. Further, the rates we pay some long distance providers are contingent upon our meeting minimum volume commitments. If we fail to meet these volume requirements, our rates may rise. Increases in the rates we pay for long distance service may make it more costly for us to provide these services to our tenants. Further, long distance providers may not provide us with access to their network facilities in a prompt and efficient manner.

We rely on Internet service providers for transmission capacity

With respect to Internet connectivity, we obtain the Internet access we provide to our tenants from Internet service providers at negotiated rates. In some instances, we must meet minimum volume commitments to receive the negotiated rates. If we fail to meet the minimum volume commitments, our rates and costs may rise. Further, Internet service providers may not provide us with access to their network facilities in a prompt and efficient manner.

We have commitments to pay third parties for transmission capacity, regardless of whether we use their services

As of December 31, 1999, we have committed to pay approximately $1.6 million for services from other communications carriers through 2001. We will have to pay those carriers even if we do not use their services.

Our business could suffer from a reduction or interruption from our equipment suppliers

We purchase our equipment from various vendors. Any reduction in or interruption of deliveries from our major equipment suppliers, such as Nortel Networks or Cisco Systems, could delay our plans to install in-building networks, impair our ability to acquire or retain customers and harm our business generally. In addition, the price of the equipment we purchase may substantially increase over time, increasing the costs we

pay in the future. It could take a significant period of time to establish relationships with alternative suppliers for each of our technologies and substitute their technologies into our networks.

We must make capital expenditures before generating revenues, which may prove insufficient to justify those expenditures

We typically install an in-building network before we have any customers in that building. Since we generally do not solicit customers within a building until our network is in place we may not be able to recoup all of our expenditures within any building. Prior to generating revenues in a building, we must incur initial capital expenditures that are usually less than $90,000 on a typical 335,000 square foot building. In November and December 1999, we entered into a number of master license agreements, the aggregate effect of which is likely to increase the average size of the buildings we serve and therefore increase our average initial capital expenditures for network installation. Our expenditures will also vary depending on the size of the building and whether we encounter any construction-related difficulties. After initial installation of our network, our capital expenditures continue to grow based on the extent to which we add customers within a building.

Any acquisitions or investments we make could disrupt our business and be dilutive to our existing stockholders

We intend to consider acquisitions of, or investments in, complementary businesses, technologies, services or products. Acquisitions and investments involve numerous risks, including:

. the diversion of management attention; . difficulties in assimilating the acquired business; . potential loss of key employees, particularly those of the acquired business; . difficulties in transitioning key customer relationships; . risks associated with entering markets in which we have no or limited prior experience; and . unanticipated costs.

In addition, these acquisitions or investments may result in:

. dilutive issuances of equity securities; . the incurrence of debt; . the assumption of liabilities; . large one-time expenses; and . the creation of goodwill or other intangible assets that result in significant amortization expense.

Any of these factors could materially harm our business or our operating results.

Our networks may be vulnerable to unauthorized access which could interfere with the provision of our services

Our networks may be vulnerable to unauthorized access, computer viruses and other disruptive problems.

Remediating the effects of computer viruses and alleviating other security problems may require interruptions, incurrence of costs and delays or cessation of service to our customers. Unauthorized access could jeopardize the security of confidential information stored in our computer systems or those of our customers, for which we could possibly be held liable.

As an Internet access provider, we may incur liability for information disseminated through our network

The law relating to the liability of Internet access providers and on-line services companies for information carried on or disseminated through their networks is unsettled. As the law in this area develops, the potential imposition of liability upon us for information carried on and disseminated through our network could require us to implement measures to reduce our exposure to such liability, which may require the expenditure of substantial resources or the discontinuation of certain products or service offerings. Any costs that are incurred as a result of such measures or the imposition of liability could harm our business.

Year 2000 problems could disrupt our business

During this calendar year, many software programs may not recognize calendar dates beginning in the Year 2000. This problem could cause computers or machines that utilize date dependent software to either shut down or provide incorrect information. If we, or any of our key suppliers, customers or service providers, fail to mitigate internal and external Year 2000 risks, we may temporarily be unable to provide services or engage in any other business activities, including customer billing, which could harm our business.

Our affiliates own approximately 58.6% of the outstanding common stock, and thus control all matters requiring a stockholder vote and, as a result, could prevent or delay a change of control

Our existing directors, executive officers and greater-than-five-percent stockholders and their affiliates beneficially own, in the aggregate, approximately 58.6% of the outstanding shares of common stock. If all of these stockholders were to vote together as a group, they would have the ability to exert significant influence over our board of directors and its policies. For instance, these stockholders would be able to control the outcome of all stockholders' votes, including votes concerning director elections, charter and by-law amendments and possible mergers, corporate control contests and other significant corporate transactions. This concentration of stock ownership could have the effect of preventing or delaying a change of control or otherwise discouraging a potential acquirer from attempting to obtain control of us, which in turn could harm the market price of our common stock or prevent our stockholders from realizing a takeover premium over the market price for their shares of common stock.

Provisions in our certificate of incorporation and bylaws may discourage takeover attempts

Provisions in our certificate of incorporation and bylaws may have the effect of preventing or delaying a change of control or changes in our management. These provisions include:

. the right of the board of directors, without stockholder approval, to issue shares of preferred stock and to establish the voting rights, preferences, and other terms of any preferred stock;

. the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;

. the ability of the board of directors to alter our bylaws without prior stockholder approval;

. the election of three classes of directors to each serve three year staggered terms;

. the elimination of stockholder voting by consent;

. the removal of directors only for cause;

. the vesting of exclusive authority in the board of directors and specified officers (except as otherwise required by law) to call special meetings of stockholders; and

. advance notice requirements for stockholder proposals and nominations for election to the board of directors.

These provisions may have the effect of preventing or delaying a change of control or impeding a merger, consolidation, takeover or other business combination, which in turn could preclude our stockholders from recognizing a premium over the prevailing market price of the common stock.

We have a shareholder rights plan that entitles our stockholders to rights to acquire additional shares of our common stock when a third party acquires 15% of our common stock or commences or announces its intent to commence a tender offer for at least 15% of our common stock. This plan could delay, deter or prevent a change of control.

Future sales and issuances of our common stock could adversely affect our stock price

Substantial sales of our common stock in the public market, or the perception by the market that such sales could occur, could lower our stock price or make it difficult for us to raise additional equity capital in the future. As of March 2, 2000, we had 47,302,202 shares of common stock outstanding. Of these shares, 11,511,100 are freely tradeable. Substantially all of the remaining 35,791,102 shares are subject to 180-day lock-up agreements. Of these shares, up to 17,004,632 shares may be available for sale in the public market on August 15, 2000, subject to compliance with Rule 144, and the balance will be available for sale at various times thereafter, also subject to compliance with Rule 144. In addition, we have also registered 11,577,100 shares of common stock for issuance under our stock option plans and 900,000 shares of common stock under our employee stock purchase plan. As of December 31, 1999, options to purchase 5,820,975 shares of common stock were issued and outstanding, of which options to purchase 1,049,091 shares have vested. Additionally, up to 11,163,990 common shares are issuable upon the exercise of warrants that were issued to several property owners and operators pursuant to stock warrant agreements and master license agreements executed in November and December 1999. These warrants are exercisable for periods of five to ten years, but cannot be exercised until August 15, 2000. We cannot predict if future sales or issuances of our common stock, or the availability of our common stock for sale, will harm the market price for our common stock or our ability to raise capital by offering equity securities.

Members of our board serve on the boards of our potential competitors, which may create conflicts of interest

Some members of our board of directors may serve as directors of other communications or Internet services companies which might compete with us. To the extent that any of these companies presently offer, or at some future point begin to offer, integrated communications services similar to the services that we provide, there may be conflicts of interest between the fiduciary duties owed by these individuals to us and the duties owed to these other companies. We have not adopted specific policy guidelines to address these potential conflicts of interest, and if these conflicts of interest arise they may be resolved on terms that are not in the best interests of all of our stockholders.

Impairment of our intellectual property rights could harm our business

We regard certain aspects of our products, services and technology as proprietary and attempt to protect them with patents, copyrights, trademarks, trade secret laws, restrictions on disclosure and other methods. Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our products, services or technology without authorization, or to develop similar technology independently.

We currently have a patent application pending for our fiber-optic infrastructure and network configuration. This patent may not be issued to us, and if issued, it may not protect our intellectual property from competition which could seek to design around or invalidate this patent.

We are aware of several other companies in our and other industries which use the word "Cypress" in their corporate names. We are in the process of attempting to secure a trademark for the name "Cypress Communications." Even if we are able to secure this trademark, other companies could challenge our use of the word "Cypress." If such a challenge were successful, we could be required to change our name and lose the goodwill associated with the Cypress Communications name in our markets.

We may have a contingent liability arising out of a possible violation of Section 5 of the Securities Act of 1933 in connection with the previous existence of a hyperlink on our website

On or about December 20, 1999, one of our employees established an unauthorized hyperlink on our website to an audio announcement regarding our initial public offering contained on an independent, unaffiliated website. The audio announcement consisted solely of a person orally announcing limited factual information regarding Cypress and the offering. This hyperlink was on our website for approximately 17 days, and was removed on January 6, 2000. This announcement may have constituted a prospectus that did not meet the requirements of the Securities Act, in which case the existence of the hyperlink may have caused us to violate Section 5 of the Securities Act.

If the existence of this hyperlink caused a violation of Section 5 of the Securities Act, we believe that only purchasers in the offering who heard this announcement through the hyperlink would have the right, for a period of one year from the date of their purchase of the common stock, to bring an action for rescission or for damages resulting from their purchase of common stock. We cannot assure you, however, that if such a violation occurred this right would be limited to those purchasers. We do not believe that the existence of this hyperlink caused a violation of Section 5, and if any such claim were asserted, we would contest the matter vigorously. Accordingly, we do not believe that our exposure, if any, resulting from the existence of this hyperlink would be material to our results of operations or financial condition.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk.

Our exposure to financial market risk, including changes in interest rates and marketable equity security prices, relates primarily to our investment portfolio. We typically do not attempt to reduce or hedge the market exposure on our investment securities because a substantial majority of our investments are in fixed-rate, short-term securities. We do not have any derivative instruments. The fair value of our investment portfolio or related income would not be significantly impacted by either a 100 basis point increase or decrease in interest rates due mainly to the fixed-rate, short-term nature of the substantial majority of our investment portfolio. As of December 31, 1999, we had no debt outstanding, other than capital leases.

Item 8. Financial Statements and Supplementary Data.

The financial statements and supplementary data are listed under Item 14(a) and have been filed as part of this report on the pages indicated.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

Not applicable.